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Before the
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Postal Rate and Fee Changes, 1997	)	Docket No. R97-1

INITIAL BRIEF OF HALLMARK CARDS, INCORPORATED

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I. INTRODUCTION

Statement of Position. In this brief, Hallmark Cards, Incorporated (Hallmark), a limited participator in Docket No. R97-1[1], will focus on fundamental issues of postal pricing. We explain why — contrary to the position of the Postal Service and some others — Ramsey pricing (or demand pricing in general) is

— not permissible as a means of ratemaking under the Postal Reorganization Act (the Act),

— infeasible on this record, and

— undesirable because of its potential effects on senders and recipients of mail.

A main reason for these conclusions is that the Act requires the Commission to set rates that foster the "educational, cultural, scientific, and informational value to the recipient of mail matter." 39 U.S.C. § 3622(b)(8). The high cultural value of greeting cards is clearly expounded in the testimony of Dr. Ken C. Erickson on behalf of the Greeting Card Association (GCA). Hallmark agrees with Dr. Erickson's conclusions and with the positions argued in the GCA Initial Brief. We show below how this cultural value as demonstrated by Dr. Erickson[2] also shows that Ramsey pricing is inconsistent with the Act. Rather, the Act requires full recognition of all the statutory pricing criteria — including those that cannot be reflected in a dollars-and-cents evaluation of changes

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[1] Hallmark is the Nation's largest publisher of greeting cards, most of which are sent as single-piece First-Class Mail, as well as a substantial user of First Class in its own business.

[2] GCA-T1, Tr.25/13151 ff.

in demand thought to result from changes in postage rates. This is what the Commission has done in past rate cases, with judicial approval. It should be done in this case as well.

The proposed one-cent increase in the single-piece First-Class letter rate. Hallmark's opposition to the use of demand pricing — either directly as a means of *setting rates or indirectly as a standard for judging rates otherwise derived* — and our advocacy of full recognition for the cultural value of First-Class single-piece correspondence in general and greeting cards in particular do not necessarily mean that we oppose the relatively small increase proposed in this docket[3]. Like many other parties, we see many potential errors in the Postal Service's data, in its costing presentation, and in other aspects of its Request. We recognize, however, that the whole-cent constraint presumably still applies to First-Class single-piece letters, and that — disparities between projected and apparent actual FY 1997 results notwithstanding — a one-cent increase may be a practical necessity.

The Commission, as Notice of Inquiry No. 5 testifies, is justifiably concerned that the revenue increase needed may be much less than the Service originally projected. The Board of Governors' letter of March 3, 1998, indicates that if the Board means to deal with this problem, it will do so by adjusting the implementation date of the new rates the Commission recommends. That Hallmark does not discuss the timing of rate implementation in the body of this brief does not mean that timing is not a significant concern: it is. Like many other major uses of the mails, the sending of greeting cards is seasonal. Implementation of higher rates in the late fall would be more damaging to the values served by greeting cards than, for example, implementation in late January

[3] The comparatively small increase in total revenue sought in this case, however, does not excuse the attempt to establish Ramsey pricing as a basis for postal ratemaking in the future.

or around mid-summer.[4] For purposes of this brief, we assume the Commission will issue its recommended decision on the originally contemplated 10-month schedule.

Outline of topics. In the body of this Initial Brief, we discuss demand pricing from several different critical viewpoints.

First, we demonstrate that Ramsey pricing as advocated by the Postal Service and others as an ideal pricing procedure is, in fact, not a legally permissible basis for setting postal rates (Part II, sections A-E, at pages 3-26 below).

Second, we explain that — even if it were legally acceptable as a postal ratemaking theory — Ramsey pricing could not be implemented on the basis of the Docket R97-1 record (Part II, sections F-G, pages 26-31 below).

Third, we show why, in any event, such demand-driven pricing could have undesirable consequences for all senders and recipients of mail. Finally, we discuss the ways in which Dr. Erickson's testimony can help this Commission more effectively carry out the mandates of the Act requiring that non-economic values to recipients as well as mailers be recognized in ratemaking (Part II, sections H-J, pages 32-39 below.)

II. ARGUMENT

A. WHY RAMSEY PRICING IS A MAJOR ISSUE IN THIS CASE

Among the odd features of Docket No. R97-1 is the existence of two distinct, and incompatible, presentations on pricing from two Postal Service witnesses. Mr.

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[4] If circumstances require, Hallmark will communicate its views on this question to the Board of Governors.

Bernstein (USPS-T31) develops what he considers to be Ramsey prices. Dr. O'Hara (USPS-T30) presents a different set of prices, purportedly based on the statute; it is these that the Postal Service asks the Commission to recommend. Dr. O'Hara advocates a one-cent increase in the first-ounce single-piece First-Class rate.[5] As neither Hallmark nor other parties especially concerned with First-Class letter postage have presented evidence against the one-cent increase, it would not be unfair to ask us why we are raising objections to Ramsey pricing. In this introduction we will answer that preliminary question.

Briefly: the theory that emerges from the Postal Service presentations is that Ramsey prices (i) are desirable, indeed ideal, in themselves; and (ii) are the standard by which non-Ramsey prices are to be judged. This is asserted even though the Act requires that fairness, impact, value to the recipient, and other non-economic factors carry the same weight as relative demand in the choice of rates. Mr. Bernstein states at the beginning of his direct testimony that

> Another purpose of this testimony is to provide a guideline for postal pricing based on the principle of economic efficiency. *To the extent that other considerations beyond economic efficiency are important to the establishment of postal rates, the cost — in terms of lost economic efficiency — of those considerations can be measured.*

USPS-T31 at 2 (italics added). Dr. O'Hara, despite having presented non-Ramsey prices, seems to agree in principle:

> I make no formal use of the Ramsey prices developed by witness Bernstein in USPS-T31. In general, however, all else being equal, I view movement of rates in the direction of Ramsey prices to be beneficial. . . .

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[5] Mr. Bernstein's Ramsey prices would seemingly lead to a greater increase for non-workshared First-Class letters. See USPS-T31 at 87, Table 17 (TYBR fixed weight index price = \$0.3934; Ramsey fixed weight index price = \$0.4505).

USPS-T30 at 21.[6]

In short, the Postal Service position[7] appears to be that Ramsey prices are the ideal, and that any departure from them entails a "loss".

Whatever the acceptability of this position may be from the standpoint of theoretical economics[8], it cannot be sustained when the task is to recommend rates that will comply with the Postal Reorganization Act. The Act recognizes relative value to purchasers — the basis of any form of demand pricing — as *but one of* the factors to be considered in ratemaking[9]. The Act also enumerates other — non-economic — criteria and does not give priority to any single criterion, except for the requirement that all classes pay their attributable costs and contribute to institutional costs. It therefore cannot be read to suggest that all other ratemaking criteria should be either glossed over if not quantifiable in "efficiency" terms, or at best applied by (1) estimating the result of applying them, (2) comparing that result with a set of Ramsey prices, and (3) deciding whether the "loss" is worthwhile. That, however, is the clear implication of Mr. Bernstein's procedure[10], and Dr. O'Hara does not dissent (see Tr. 2/319-321).

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[6] The remainder of the quoted paragraph tends to show that in the next case, and perhaps all future cases, Dr. O'Hara would be less restrained in his preference for Ramsey prices.

[7] Evidently shared, at least as a matter of principle, by OCA witness Sherman (OCA-T300). Tr. 26/13711-13713.

[8] In fact, theoretical doubts on this score arise as soon as it is recognized — as the Act does recognize — that substantial and unquantifiable externalities are associated with sending and receiving mail. See section D, below.

[9] 39 U.S.C. § 3622(b)(2).

[10] Made explicit at Tr. 10/5103 ("the way to deal with these ECSI considerations is to view the Ramsey price as a price in the absence of those considerations and then make an adjustment as warranted").

Because the Commission, as it has more than once pointed out[11], treats pricing as an evolutionary process in which past decisions are weighed and relied on, it is important to reject this theory of Ramsey pricing now rather than letting it become established. The rejection should be unambiguous, to foreclose future argument that the Commission has approved Ramsey pricing inferentially. The Postal Service's presentation does not recognize that the Commission's past practice has been — as the Act requires — to exercise its judgment in combining the economic (demand) and the non-economic pricing criteria so as to arrive at rates satisfying them all. As the Commission observed in the last general rate case,

> . . . in contrast to costing analyses, economic theory offers guidance on only a few of the nine pricing criteria of section 3622(b). Few of these criteria are quantifiable through mathematical modeling. As a result, the guidance that economic theory offers is mostly qualitative. *Selecting a single set of rates that satisfies all of the pricing criteria requires the Commission to judgmentally determine how to interpret the various pricing criteria and the weight to be accorded to each.*

PRC Op. R94-1, Appendix F, ¶ 149 (italics added). In particular, the Commission's historic refusal to let the Ramsey theory trump the other criteria has been judicially approved. *Direct Marketing Association* v. *U.S. Postal Service,* 778 F.2d 96, 104 (2d Cir. 1985); and see *National Association of Greeting Card Publishers* v. *U.S. Postal Service,* 607 F.2d 392, 404 (D.C. Cir. 1979).[12] In this case the Postal Service has

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[11] PRC Op. R90-1, ¶¶ 4011, 4109; PRC Op. R94-1, ¶¶ 4022, 4060.

[12] In Docket No. R87-1, the Commission reviewed these and other court decisions, and concluded:

> . . . we once again (cf. PRC Op. R84-1, paras. 4129 ff.) reject the idea that "value of service" (in the limited sense of relative demand) swallows up the other pricing criteria, or that — regardless of the structure of the Act — it is inherently prior to any other pricing consideration. Its theoretical utility as an economic-efficiency concept does not affect our obligation to give appropriate weight to the noneconomic values

treated *pricing as a process* whose outcomes must be judged (and, presumably, in some cases modified) by standards of economic demand pricing, even if they do not themselves comply with those standards. In what follows we will show in detail why this view must be rejected.

B. USING THE "LOSS" COMPARISON BETWEEN RAMSEY AND NON-RAMSEY PRICES WOULD VIOLATE THE STATUTORY RATEMAKING STANDARDS

"Loss" of what? The Ramsey pricing approach we urge the Commission to reject equates lost "economic efficiency" with "loss" in general. For example, witness Bernstein states that his purpose is to show

> . . . a methodology for evaluating the costs — in terms of lost economic efficiency — of other considerations that they [*sc.*, participants in the case] may use to propose and establish postal rates.

Response to ABP/USPS-T31-1(a), Tr. 10/4986. This is Mr. Bernstein's way of comparing the "losses" from two different price schedules. But the clearest explanation given by Mr. Bernstein of what he means by "loss" in general is this:

> The social loss as it relates to my testimony is defined as the sum of the change in consumer surplus and the change in Postal Service net revenues. This sum is negative because raising net revenues requires *pricing above marginal cost and prices above marginal cost* lead to a decline in consumption. The social loss is related to this decline in consumption since units not consumed provide no benefit to mailers or

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> Congress directed us to consider. An equity conclusion, or a judgment as to the educational value of certain mail, is not to be governed or modified by efficiency concerns — any more than principles of equitable treatment should be allowed to dictate the way in which we judge the relative efficiency of different sets of prices.

PRC Op. R87-1, ¶ 3021 (fn. omitted).

> the Postal Service. Any postal rate schedule that satisfies the break-even requirement will result in a social loss. Ramsey pricing minimizes this social loss and therefore minimizes the loss of mailer consumer surplus since Postal Service net revenues are the same under any pricing schedule.

Response to ABP/USPS-T31-5, Tr. 10/4991. Thus — to the extent the Act permits "loss" to occur at all[13] — the theory as presented by Mr. Bernstein recognizes no form of "loss" except the value of postal services that are not purchased as a consequence of their unit price exceeding marginal cost.[14] In other words: "social loss" as used in this theory impinges *only* on those who would like to send mail (i.e., purchase postage) but have to refrain because of the price. Mr. Bernstein presents Ramsey pricing as the way to minimize this loss.

OCA witness Sherman generally agrees.[15] He describes the consumer surplus lost when a price is raised above marginal cost, and consumption consequently declines, as "the net welfare loss of raising price above marginal cost in order to cover fixed costs." OCA-T300 at 11, Tr. 26/13718.

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[13] As Mr. Bernstein notes, the Postal Service must, under any pricing regime, recover enough net revenue to cover its institutional costs.

[14] See Mr. Bernstein's response to OCA/USPS-T31/3, quoted below. This loss should be distinguished from what Mr. Bernstein calls "burden on consumers" (see, e.g., USPS-T31 at 9, 26). Burden on consumers comprises both (i) what the purchaser must pay in additional to marginal cost, in order to allow the Postal Service to break even, and (ii) the value of consumption forgone because of the prices implied by (i). For some purposes, however, Mr. Bernstein seems prepared to treat "burden on consumers" as equivalent to (i) alone; see USPS T-31 at 26, lines 12-17. In any event, both notions relate to what someone is made to pay — or what someone else declines to pay — in order to send mail. Likewise, Dr. Sherman considers that the dollars above marginal cost which mailers must pay are canceled out by the "benefit" represented by the Service's covering institutional costs. OCA-T300 at 10-11, Tr. 26/13717-13718. These treatments ignore the loss to others from *not receiving* mail.

[15] Compare Mr. Bernstein's Exh. 1 (USPS-T31 at 12) with Dr. Sherman's Figure 1 (OCA-T300 at 12), Tr. 26/13719.

Is this all there is to social welfare? Both witnesses, therefore, treat mailers' forgone consumption as if it were the entire loss to society. They thus attach distinctly globalizing labels to the forgone-consumption triangles on their respective illustrations. It is time to consider whether, in the context of the Postal Reorganization Act, it is really possible to equate the welfare of society, in its postal aspect as defined by Congress, solely with the decisions of mailers to purchase or not purchase (a certain quantum of) postal services.

Value to recipients. The first specific question is: How would the procedure advocated by Mr. Bernstein and concurred in, so far as basics are concerned, by Dr. Sherman, recognize the value of a mailpiece to the recipient? The short answer seems to be that it does not.

Mr. Bernstein, responding to an OCA interrogatory, clarifies this helpfully:

> Dollars spent on mailing are not equal to the value that households place on or receive from such mail. *It is important to distinguish between the value of the service provided by the Postal Service and the value to either the sender or the recipient of the item being mailed.*
>
> * * *
>
> The same kind of reasoning can be applied to your hypothetical examples. Suppose that the bank mailing, the advertising flyer, and the periodical mailing each cost the mailer 25 cents. *Since these items were mailed, it must be the case [that] the value of the service provided by the Postal Service must be at least 25 cents. That is the value measured by the demand curves for each of these mail products and it is from these demand curves for various postal services that my calculations of Ramsey prices and gains to consumers are based.*
>
> Consider first the bank statement. *The householder may place a value of, say, five dollars on the bank statement, but the value of the bank statement . . . is not the issue. The issue is whether it is worth 25 cents for the householder to receive a statement in the mail as opposed to some other option such as having the householder pick-up the statement at the*

bank, mailing statements on a bi-monthly or quarterly basis, or faxing the statement to the householder's home computer. . . .

Response to OCA/USPS-T31/3, Tr. 10/5043-5045 (italics added). In discussing the OCA's other examples, Mr. Bernstein speculates on how the value to the recipient of an advertisement or a magazine can exceed the postage cost.[16] The discussion presupposes that the mailer will go on sending similar items to recipients as long as doing so is economically productive *for the mailer.* The value of mail to the recipient[17] must be looked at in a different light once it is admitted that often the communication is not intended to have any economic value to the sender.

In fact, Mr. Bernstein's explanation confuses the distinction between the value to the sender of, for example, a bank statement and the value of that document to the recipient. To the bank, the postage on that statement is a factor of production like paper or tellers' wages. Its value to the bank is measured by the revenue the bank gets on account of having used it.[18] Thus measuring only the value to the sender of

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[16] In the bank statement case, it is at least possible that the householder pays the 25-cent postage cost. In the magazine case, Mr. Bernstein says explicitly that "the cost of this subscription is $12, of which $3 represents a 25 cent postage charge for each issue." Apparently, therefore, the cost of postal services sometimes does get factored into the value of the mail to the recipient, through charges made for the mail matter itself or for maintenance of a business (e.g., banking) relationship with the recipient.

[17] Here, as elsewhere, we include as "recipients" other persons besides the one whose name and address appear on the envelope, to the extent that that addressee shows or circulates the communication to them. Christmas cards displayed on a table for friends to see may thus have many "recipients." Dr. Erickson demonstrates the importance of this sharing of postal communications at GCA-T1, pp. 17-18, 37-38, 41; Tr. 25/13174-13175, 13194-13195, 13198; and see Tr. 25/13238, 13248-13249, 13258.

[18] In more technical language, the demand curve for a factor of production is its marginal revenue product (i.e., marginal revenue times marginal physical product). The value of a letter stamp to a business just equals the number of additional units of product it could produce as a consequence of using that stamp, multiplied by the amount increase in the bank's total revenue associated with selling those additional

business mail in fact ignores the mail's value to the recipient. In deciding whether to send mail, the business mailer considers its internal marginal cost curve; it does not consider externalities (costs and benefits incurred by others who are not parties to the postage-purchase transaction).[19] When negative externalities (costs imposed on non-parties) are ignored, as when the product is priced at the firm's (internal) marginal cost, society gets more of the product than would maximize social welfare — a failure to produce allocative efficiency. When positive externalities are ignored, correspondingly, society gets too little of the product — another failure of allocative efficiency. The price which would yield the social optimum in the presence of positive externalities (assuming no offsetting negative ones) is lower than the price determined solely by (internal) marginal cost, and the socially optimal output would therefore be larger. Marginal cost pricing is said to be the "optimal" or "first-best" method of achieving allocative efficiency (which *in the absence of externalities* may be true), and Ramsey pricing is the "second-best" method. Since, where there are externalities, even marginal-cost pricing does not produce allocative efficiency, there is no point in trying to approach allocative efficiency through the Ramsey "second-best" procedure.

In short, the difficulty ignored in the Bernstein-Sherman approach is that —

1. While departing from Ramsey prices may be thought to produce a "loss" expressible in terms of economic efficiency,

2. the suppression of demand that is the goal and effect of Ramsey pricing may also produce a real loss, not recognized in the Ramsey formula, but adversely affecting interests which Congress has directed the Commission to promote.

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units of product.

[19] On externalities generally, see Paul A. Samuelson and William D. Nordhaus, *Economics* (16th ed., 1998) at 274. The Commission recognized the usefulness of this concept for its ratemaking procedures in Docket No. R87-1, ¶ 3022.

Non-quantifiable values. The second necessary question is how the Bernstein-Sherman procedure would deal with the value of mail matter to recipients[20] when such recipient value is, wholly or in part, not quantifiable.[21] Again, it seems that under their approach value to recipients cannot be recognized. The Act, however, explicitly directs that it must be recognized.

For instance, § 3622(b)(8) requires consideration of the "educational, cultural, scientific, and informational value to the recipient of mail matter." As Dr. Erickson's evidence for the Greeting Card Association clearly shows, there is a large volume of mail which is not part of business transactions and whose (non-economic) value to the recipient is difficult or impossible to quantify. If the Commission is to "maximize welfare" in recommending rates, the Act requires it to do so using a definition of "welfare" that includes these values. The Ramsey economic procedure does not include them; consequently, it cannot be used either directly or as a standard for judging the acceptability of pricing approaches that do.

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[20] Or, indeed, to the sender. The figures drawn by witnesses Bernstein (USPS-T31, Exh. 1) and Sherman (OCA-T300, Fig. 1, Tr. 26/13719) to illustrate the loss of welfare from forgone consumption implicitly quantify that loss with reference only to volume and price. If "welfare" is defined more broadly, these diagrams understate the externality-related loss *to senders* — as well as ignoring the loss to recipients. In other words, not all welfare issues have to be *economic* welfare issues. I. M. D. Little, *Critique of Welfare Economics* (2d ed., 1970), at 189; quoted in PRC Op. R87-1, ¶ 3012, fn. 2). Defining "welfare" broadly in this case is thus entirely reasonable, especially given the requirements of the Act.

[21] The Commission recognized that some criteria are mathematically expressible and others are not (e.g., PRC Op. R87-1, ¶ 4007), and has promised to guard against the "tendency to give greater weight to empirically quantifiable benchmarks than to purely qualitative ones." PRC Op. R94-1, Appendix F, ¶ 154. It is unfortunate that the USPS pricing witnesses did not follow suit.

Long-term considerations. The Commission relies on its previous pricing decisions as precedents. Consequently, in view of the precedential effect of Commission decisions, it is not enough to look at the bottom line of a Postal Service proposal — i.e., in this case, at Dr. O'Hara's rate profile — to see if it is satisfactory: the Commission should also consider whether its (claimed) foundations would be acceptable in a future case. In this docket, Dr. O'Hara has been relatively forthright in limiting the forward effect of his own departures from demand pricing principles:

> I make no formal use of the Ramsey prices developed by witness Bernstein in USPS-T-31. In general, however, all else being equal, I view movement of rates in the direction of Ramsey prices to be beneficial. Therefore, whether a particular rate level would move rates closer to, or farther away from, Ramsey prices was one of the many factors I considered in evaluating potential rate levels. In this case, given *the modest overall increase, the Postal Service's desire to keep the increase for all subclasses close to the overall average where possible, and its desire to exercise restraint in reflecting the new costing information in rate levels, the consideration of movement toward or away from Ramsey prices did not have a major effect on my conclusions.*

USPS-T30 at 21 (italics added), and see Tr. 2/320-321. Thus in explaining his departure from Ramsey prices, Dr. O'Hara lists two factors (uniformity of increases; restraint) which may not, and one (novelty of the costing methods) which presumably will not, characterize the Service's next request.[22] No such qualification attaches to his *endorsement* of Ramsey principles.

C. THE RIGHT WAY AND THE WRONG WAY TO ACCEPT THE POSTAL SERVICE'S RATE PROPOSALS

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[22] Indeed, it is generally true that the Postal Service in this case attempts to persuade the Commission of the merits of Ramsey prices without providing evidence of their probable concrete effects in the long run on senders and recipients of the various types of mail.

If the Commission, after full consideration of the record, decides that (i) a rate increase is warranted[23] and (ii) the Postal Service's proposed rates are — simply as rates — in compliance with the Act, it neither can nor should accept them together with the Postal Service analysis that purports to justify them. If the Commission can accept rates substantially like those the Service proposes, it must accept them on the basis of its own independent consideration and application of all the statutory factors, treating all the factors as co-equals[24] as in the past (and as Congress intended) — and not merely because it decides that the "welfare loss" ascribable to the use of factors other than relative demand can be tolerated.

D. STATUTORY FACTORS GOVERN THE CHOICE OF RATES — AND HENCE THE CHOICE OF RATEMAKING METHODS

The statutory provisions governing postal ratemaking in general, and pricing in particular, require effective consideration of the interests of recipients of mail. Giving demand pricing principles the status of a "super-criterion" by which to judge attempts to apply the other criteria would therefore violate the Act.

Section 3622(b)(8). The most obvious provision calling for recognition of recipient value is § 3622(b)(8): "the educational, cultural, scientific, and informational value to the recipient of mail matter[.]" Demand pricing attempts to ration demand so

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[23] Cf. the responses to Notice of Inquiry No. 5 and the OCA's arguments in the first section of its initial brief (March 16, 1998).

[24] We recognize that the Commission and the courts give weight to the word "requirement," used uniquely in § 3622(b)(3) to characterize recovery of attributable cost and assignment of some portion of all other costs. But demand pricing — insofar as the Commission could legally consider it — would presume that attributable costs had been recovered and the "requirement" thereby largely met. Equality of status pertains to the *pricing* factors in the strict sense.

as to maximize economic utility[25] to the purchasers of the good being priced — here, postal services. Since the recipient of a greeting card or other mailpiece having recognizable educational, cultural, scientific, or informational value is not the purchaser, there is an immediate conflict between the requirements of the Act and the procedures inherent in demand pricing. This is so because demand pricing ignores two components of value which the Act requires be recognized.

The unpriced value to the mailer of a postal transaction. Demand pricing estimates the quantity *Q* of a good that will be bought at a given price *P*, and the change in *Q* that will be observed with a specified change in *P*. This is of course unobjectionable as far as it goes, but it is far from measuring all the values which are meaningful *even to the purchaser* and which are affected by the change in price.[26]

For example, Dr. Erickson testified on behalf of the Greeting Card Association that the sending and receipt of greeting cards has value in that it maintains family relationships. In doing this it exhibits cultural value, since these relationships are integral to culture. Tr. 25/13151 ff. He also testified that sending and receiving greeting cards is part of other important cultural communications. It follows that the greeting-card sender (stamp purchaser) places value not just on the postal service received but also on the relationship which the card reinforces or renews. This value is not reflected in the reaction of individuals to an increase in the price of a letter stamp. Two individuals, for instance, may place the same value on maintaining a personal

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[25] This concept of utility is valid only within the boundaries of the relevant branch of economic analysis — that is, it covers only those benefits or detriments that can be measured by a price. We distinguish it from "welfare," which we elsewhere use in a much broader sense.

[26] Put another way: the theory assumes that all of the value the good has to the purchaser is accounted for by the purchaser's consumption of the good. It thus ignores any higher-order motives the purchaser may have for making the purchase — and the elements of value those motives subserve.

correspondence relationship with a distant sibling, but — in the view of demand pricing analysis — place different values on the purchasable components of that relationship (cards, letter paper, stamps) because of other factors such as income[27].

Demand pricing would ignore the former category of value and concentrate on (part of) the latter. If its empirical procedures seem to show that mailers of First-Class letters attach a high value to the purchase of first-ounce letter stamps, that mail category will be taxed with a high proportion of institutional costs. But such a tax falls, in reality, not just on the purchase of postage but also on the mailer's maintenance of the relationship.

Value to recipients. A more self-evident shortcoming of demand pricing, in terms of the Act, is that it either ignores value to recipients or assumes that, whatever than value may be, it is "priced back" through the sender and so reflected in the sender's response to price changes.[28]

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[27] See USPS-T6 (Tolley) at 19, 38-40, and Table 2. Dr. Tolley testified that one-percent increase in real permanent income per adult causes an increase in single-piece First-Class letter volume of about one-half of one percent.

[28] This style of thinking may lead to some of the confusion we see between the value of mail to recipients as such, and the value which senders derive from the contingent circumstance that a recipient finds the mail valuable. For example, an advertising catalog received in the mail from merchant M may be valued by recipient X because he finds in it something he wants to buy, and disvalued by recipient Y because after expending time reading it she finds in it nothing of interest. X may be said to value the mailpiece (cf. Mr. Bernstein's response to OCA/USPS-T31-3, Tr. 10/5043-5045), and if there are enough Xs (or few enough Ys) on the sender's list to justify a mail advertising program there is a sense in which X's value feeds back to M and into M's postage-purchasing decisions. That this is not the sense required by the Act becomes clear if we recognize that a sufficiently large proportion of Ys will result in M's ceasing to mail catalogs — so that X's positive valuation of the mailpiece is ignored. Similarly, the analysis fails to consider any negative value (cost) to Y from receiving and dealing with unwanted mail. The Commission has stated that it is not necessarily possible to take account of value to recipients "by observing the price senders are willing to pay." PRC Op. R87-1, ¶ 4081, fn. 11. Postal Service witness Bernstein

To the extent that the Ramsey theory simply ignores the (non-economic) value of receiving a greeting card or other piece of mail, it cannot be squared with the Act; nor can it be used as a canon for judging pricing approaches that do not ignore that value; nor can departures from the prices generated by the theory be said, without qualification, to produce a "loss."

The other possible argument — that the value of mail to recipients is somehow implicitly reflected in the sender's decision to purchase or not purchase postage — is equally untenable. As the Commission has recognized, some of the values that must be reflected in postal rates are not susceptible to quantification. If there is a felicific calculus capable of representing numerically the value of a birthday card received from a family member, it has not been presented on this record. As the Commission held in Docket No. R87-1,

> . . . *Such goals as an equitable rate schedule, or the appropriate* reflection of educational, scientific, cultural and social value of mail [§ 3622(b)(8)] are not necessarily recognized in the proper way by being *assigned a numerical value and fed into a mathematical pricing technique* essentially aimed at maximizing aggregate efficiency. They are, in substance, noneconomic concepts. Trying to squeeze them into an economic model will do justice neither to them nor to the model.

PRC Op. R87-1, ¶ 3015 (fn. omitted).

Another way to express this — also recognized by the Commission in Docket No. R87-1[29] — *is to acknowledge that there are such things as externalities*[30] and that

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doubted the feasibility of factoring such values into a Ramsey equation. Tr. 10/5103-5104.

[29] At PRC Op. R87-1, ¶ 3022. In declining to attempt to include ECSI or equity considerations in a Ramsey formula, the Commission noted that they could be labeled "externalities" and that a pricing formula might, hypothetically, seek to internalize them. It quoted Postal Service witness Baumol, who accepted that possibility (noting, in the process, that the resulting formula would "yield prices . . . which could vary

the Postal Reorganization Act requires some of them to be taken into account in ratemaking. This means more than merely a Ramsey calculation that is more complex (and probably more infected with arbitrary assumptions about the dollar value of inherently non-economic benefits and costs) than would otherwise be the case. It means also that *even a "pure competition" solution, with prices precisely equal to marginal cost, would misallocate resources.* If the institutional structure of postal services and postal pricing attaches importance to the social and cultural benefits of *receiving* greeting cards, as described by Dr. Erickson, and prices are (for simplicity's sake) set at marginal cost, then the resulting prices could simultaneously (i) satisfy the Ramsey condition of "efficiently" allocating resources and (ii) result in a loss to society in the form of diminished socio-cultural benefits owing to the non-receipt of culturally valuable mail. (For additional discussion of this point, see § II.J, below.) Mr. Bernstein, however, confirms that his "analysis does not take into consideration externalities as they are considered to be at most of second order importance." Response to OCA/USPS-T31-4, Tr. 10/5046.

The equal status of the explicit statutory pricing criteria. The pricing criteria of § 3622(b) are each of co-equal status. In *Direct Marketing Association,* the Second Circuit stated:

> . . . it is clear that no single factor was intended by Congress to be the "primary" factor in making the assignments [of institutional costs]. *Newsweek,* 663 F.2d at 1200. All of the factors must be considered, *id.* . . . Indeed, "that the Senate Report refers to all of the specific factors of

substantially from those that would emerge from a barebones inverse elasticity calculation"). It also raised, while declining to decide, "the question . . . of whether all such considerations can be nonarbitrarily reduced to monetary terms and compared with a certain increment in economic efficiency." Id., fn. 7. Mr. Bernstein's procedure in this case seems close to what Dr. Baumol called a "barebones" calculation.

[30] Externalities are discussed in more detail at pages 10-11, above, in connection with Mr. Bernstein's presentation.

> section 3622(b) as 'requirements' is a strong indication that no one factor was intended to carry more weight than any other." *Id.* at 1199.

778 F.2d at 104. See *Mail Order Association of America* v. *U.S. Postal Service,* 2 F.3d 408, 425-427 (D.C. Cir. 1993), and PRC Op. R87-1, ¶¶ 3011, 3017-3021.

The pricing criteria of § 3622(b), though equal in status, cannot all be applied in the same way. We have shown that § 3622(b)(8), requiring attention to "ECSI" value, is not subject to quantification. The same might be said of subsections (b)(1) (fairness and equity), and (b)(4) insofar as the "effect of rate increases upon the general public" component encompasses consequences not reflected in economic decisions. Demand pricing, however, is a theory whose principal claim is that it demonstrates *quantitatively* "what will happen" under a particular set of prices. When some of the effects of prices both (i) are of (mandatory) interest to the price-setter and (ii) are not subject to quantification, then demand pricing cannot *adequately* demonstrate "what will happen": it must either ignore or misrepresent some of the effects that must be considered.[31] Indeed, insofar as it concentrates on the effect of price changes on volume demanded, the Ramsey model responds to only *one part* of *one* § 3622(b) factor.

That one factor is subsection (b)(2):

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[31] In Docket No. R87-1, Mail Order Association of America (MOAA) witness Sobin argued that ECSI value could and should be incorporated in a Ramsey formula, thereby "allow[ing] those interested in reviewing and analyzing the Commission's rate design and pricing decisions to measure the impact of relative ESCI [sic] values on rates for different subclasses more precisely than is possible when the Commission simply describes the process in prose." PRC Op. R87-1, ¶ 4006. The Commission rejected this contention for a number of reasons, noting that the model assumed "that the ECSI values of mail to different recipients can be reduced to measurable dollar terms and traded off against other values or among themselves" (Id. at ¶ 4007, fn. 2; and see ¶ 3022, fn. 7) and that not all statutorily-required considerations can be represented numerically. In this case, Postal Service witness O'Hara testified that he had not sought to give numeric weights to the ratemaking criteria. Tr. 2/313-314.

> . . . the value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to the collection, mode of transportation, and priority of delivery.

Ramsey pricing addresses what the mailer will pay. However, as *Direct Marketing Association* makes clear,

> . . . value of service as embraced by subsection (b)(2) "embodies two concepts: what the customer gets and what he will pay." Kappel Commission Report at 132. . . . DMA's approach [favoring demand pricing] focuses on what the customer will pay, and largely ignores what the customer gets. The latter consideration, referred to by the Postal Service as "intrinsic value," involves the criteria actually set forth in subsection (b)(2): collection, mode of transportation, and priority of delivery. . . .

778 F.2d at 104.

E. THE "RATIONING" FUNCTION OF DEMAND PRICING IS UNACCEPTABLE AS A RULING PRINCIPLE OF POSTAL RATEMAKING

Demand pricing is a means of selectively suppressing demand. Advocates of demand pricing naturally emphasize the beneficial (or, perhaps more accurately, detriment-minimizing) effects it claims to produce. Demand pricing attempts (i) to regulate demand for a set of products produced by a firm experiencing increasing returns to scale (and hence unable to sell its outputs at marginal cost without incurring growing deficits), and (ii) in doing so, to sacrifice the least utility to customers for all of *the firm's products — those customers being considered as an undifferentiated* aggregate. Thus its effects are, by nature, effects on demand — meant to be felt exclusively within the market(s) for those products.

If the markets in question are competitive, and if the price-setter is not required, by legislation or otherwise, to consider effects outside those markets, there may be few *theoretical* problems in attempting to apply demand pricing. But to state these qualifications is to suggest that demand pricing does not comply with the basic rules Congress laid down for postal ratemaking. As the Commission held in Docket No. R87-1, postal ratemaking *is* concerned with effects outside the market for postal services:

> An important part of that structure [*sc.*, of § 3622] is its aim to produce certain effects, judged to be desirable for noneconomic reasons, by means of postal rates. Moderation of the institutional cost burden to be borne by educationally valuable material [subsection (b)(8)] is a policy whose effects are expected outside the "market" for postal services. . . . The Congressional decision that some nonpostal behavior (reading, charitable giving) should be encouraged by postal pricing implies a pricing standard unrelated to the postal market. . . .

PRC Op. R87-1, ¶ 3018.

Fostering communication or rationing demand? The most basic question is whether the Postal Reorganization Act, considered as a whole, seeks to promote postal communication — or to ration it so that it is sold cheapest to those who "value" it least.[32] A number of statutory provisions make it clear that Congress wanted more postal communication, and in particular wanted postal rate schedules that would produce that result.

Section 101(a) of the Act sets out basic policy:

> § 101. Postal policy
>
> (a) The United States Postal Service shall be operated as a basic and fundamental service provided to the people by the Government of the

[32] We recognize, of course, that elements of these two general tendencies can and must coexist in ratemaking (and not just postal ratemaking). That they can be accommodated to one another in practical ways is shown by the Commission's long and largely successful history of balancing the conflicting requirements of § 3622(b). That they were meant to be accommodated is shown by the fact that those conflicting requirements were enacted in the first place.

> United States, authorized by the Constitution, created by Act of Congress, and supported by the people. The Postal Service shall have as its basic function the obligation to bind the Nation together through the personal, educational, literary, and business correspondence of the people. It shall provide prompt, reliable, and efficient services to patrons in all areas and shall render postal services to all communities. The costs of establishing and maintaining the Postal Service shall not be apportioned to impair the overall value of such service to the people.

Rates, in turn, are to comply with this policy; the Commission is bidden to "make a recommended decision on the [Postal Service's] request . . . *in accordance with the policies of this title* and the following factors[.]" 39 U.S.C. § 3622(b) (italics added). Thus giving "super-criterion" status to demand pricing principles would not be incorrect just because it would privilege one explicit pricing criterion above the rest — though that is surely true — but because suppression of (some) demand on allocative-efficiency grounds would violate the basic policies of the Act.

The Act establishes "bind[ing] the Nation together" as a fundamental purpose, without qualification. The Postal Service is not called upon to bind the Nation together just to the extent it seems economically efficient to do so. Neither is it to give preference to those types of communication it thinks most likely to be diverted to non-postal media if rates increase. Rather, it is to bind the Nation together by the *entire* correspondence of the *entire* people.[33] This statutory principle makes it plain that the

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[33] It might, we recognize, be argued that strict demand pricing would help avoid allocating postal costs in such a way as to impair the overall value of the service to the people — for the very reasons suggested in the Ramsey theory itself. But that argument would rest on a fallacy already identified: treating "value" as if it meant only "value to senders, as measured by the willingness of senders to pay for postage." Indeed, the Commission recognized this in Docket No. R84-1, noting that § 101(a) "does not refer to economic efficiency" and that

> The 'value of such service' not to be impaired apparently refers to the personal, educational, literary, and business correspondence of the people. While we agree that rates should be economically efficient, to the

demand-rationing purpose of demand pricing is not meant to dominate, directly or indirectly, the ratemaking process.

Indeed, this point was made almost twenty years ago in *National Association of Greeting Card Publishers* v. *U.S. Postal Service,* 607 F.2d 392 (D.C. Cir., 1979; Leventhal, J.):

> In terms of economic efficiency, the advantage of marginal cost pricing for regulated utilities is that it serves as a means of "encouraging the maximum economic use of a company's services consistent with the so-called 'full-cost' requirement." A corollary is its potential for close control of consumer demand, by assuring that consumption choices reflect the current costs to society of providing the resource. Marginal cost pricing has attained some currency in electric power ratemaking, where efficient utilization of increasingly scarce energy resources is a matter of primary concern.
>
> In the context of postal ratemaking, however, the dominant objective of Congress, as ascertained by the court in *NAGCP I,* was not so much the regulation of demand for postal services, as the prevention of discrimination among the mail classes. In any event, the concern for maximization of the use of capacity is less compelling where demand is inelastic. . . . *This is not the only context in which a concern for equal or* fair treatment yields results different from those obtainable if economic efficiency in the allocation of resources were the exclusive or even the dominant goal. The choice of goals and objectives is a policy choice of the legislature . . . .

607 F.2d at 403-404 (fn. omitted).[34]

> people. While we agree that rates should be economically efficient, to the extent possible, it seems clear that economic efficiency cannot be a justification for impairing basic and fundamental postal services.

PRC Op. R84-1, ¶¶ 4130-4131.

[34] The *NAGCP III* opinion, of course, assumed the validity of the same court's decision in *NAGCP I (National Association of Greeting Card Publishers v. U.S. Postal Service,* 569 F.2d 570 (1976)). But as the Commission has observed, the Supreme

Are we looking for a Pareto-optimal solution? Another way to appreciate the inappropriateness of Ramsey pricing is to compare the institutional setting of postal ratemaking with the conditions normally thought to justify seeking Pareto optimality.[35]

Pareto optimality in the allocation of resources (as by a set of prices in a market economy) may be briefly defined as the state in which production and distribution cannot be reorganized to increase the utility of one or more individuals without decreasing the utility of others. Ramsey prices, *where the economic setting is appropriate for them,* lead to Pareto optimality. But:

1. Pareto optimality, where it exists, is a characteristic of the entire economic setting — not just of one market (such as that for postal services).

2. Pareto optimality is a very weak social goal.[36] Legislatures commonly add or substitute other goals which seem to them and those they represent to be more significant; the general policies underlying the Postal Reorganization Act are an example.

Court's disapproval of *NAGCP I* in *NAGCP IV (National Association of Greeting Card Publishers v. U.S. Postal Service,* 462 U.S. 810 (1983)) went only to costing issues and not pricing. PRC Op. R87-1, ¶ 3020.

[35] See response to NAA/USPS-T31-15, Tr. 10/5020-21 (Bernstein).

[36] A setting in which a dictator has $100 billion and each of his subjects has $10 is Pareto optimal, in that the dictator's wealth cannot be redistributed without making him worse off. Paretian optimality analysis leaves some important issues untouched, including what to do about rights (in contrast to utility) or about moral values. See A. K. Sen, "The Impossibility of a Paretian Liberal," *Journal of Political Economy,* vol. 78 (1970), pp. 152-157; A. K. Sen and B. Williams (eds.), *Utilitarianism and Beyond* (1982) at 7.

It has been persuasively argued[37] that, if one or more of the conditions for Pareto optimality cannot be satisfied because of the institutional setting, it is generally neither necessary or desirable to satisfy the remaining Pareto conditions. Here, the most obvious departure from those general conditions is that Congress has imposed additional, potentially costly social goals that would not be imposed by a completely free market.[38] In addition, the Postal Service has, through the Private Express Statutes, an extraordinary level of market power with respect to much of its volume. Pareto optimality must stand or fall on the basis of the entire economy. Because it thus takes as a precondition the absence of the monopoly rents — which occur in our present-day setting where many concentrated industries price their products well above marginal cost — the "whole-economy" condition cannot be met either. If the point of Ramsey pricing is to produce a situation in which no consumer can be made better off without harming one or more other consumers, then, as regards postal ratemaking, it is an illusion.

The Act does not make the Postal Service and postal patrons interchangeable in assessing "total surplus." To the extent that the Bernstein-Sherman approach treats benefits to the Postal Service and benefits to (all) its customers as interchangeable for the purposes of counting up total surplus, it is equally inconsistent with the Act.[39] Undifferentiated maximizing of total surplus (i.e., producer plus consumer surplus) is not a stated goal of the legislation; and where the "producer" is declared in the first

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[37] R. G. Lipsey and K. Lancaster, "The General Theory of Second Best," *Review of Economic Studies,* vol. 24 (1956-57), pp. 11-32.

[38] Apart from the broader goals laid down by, e.g., § 3622(b)(8), Congress has at various times and in various ways directed that taxpayers or mailers in general are to be somewhat "worse off" in order that qualifying nonprofit organizations may send certain types of mail matter at reduced rates.

[39] Tr. 10/5097-5100 (Bernstein); Responses NAA/USPS-T31-5 at Tr. 10/4991-92; NAA/USPS-T31-21, Tr. 10/5034-36; OCA/USPS-T31-1, Tr. 10/5038; OCA/USPS-T31-2, Tr. 10/5040-42; OCA/USPS-T31-10, Tr. 10/5054-58.

sentence of the first section to be a fundamental service provided *by* the government *to* the people it cannot reasonably be inferred as a Congressional purpose. Instead, the Act seeks to provide benefits to the people — not to a theoretical aggregate comprising the people plus the Postal Service itself. Indeed, if Congress had meant undifferentiated total surplus to be maximized without regard to other objectives, rationing of demand in the (sole) interest of allocative efficiency would necessarily follow. We showed above, however, that the Act cannot be read to require such rationing.

F. THE TECHNICAL PROBLEMS INHERENT IN APPLYING RAMSEY PRICING TO THE POSTAL SERVICE DISQUALIFY IT AS A CANON FOR JUDGING POSTAL RATES

The notion endorsed by various witnesses that Ramsey pricing can be used as a standard by which to judge postal rates, even if for statutory reasons non-Ramsey prices have to be recommended to the Governors, stands or falls by the accuracy and reliability with which the Ramsey procedure generates "efficient" prices. The theory at its most basic requires accurate costs and accurate elasticities. If these fundamental numbers are unavailable, incorrect, or incomplete, the results will not be "efficient" rates for the real Postal Service but a set of more or less arbitrary prices reflecting erroneous inputs rather than the real world. In other words: garbage in, garbage out. If the prices produced by such a Ramsey exercise are not real-world efficient prices, then any estimation of "welfare loss" sustained in departing from them will be no more valid.[40]

[40] Difficulties of this kind are of such significance that William J. Baumol, known earlier as a strong proponent of Ramsey pricing, has more recently explained that regulators should not attempt to use it to generate precise rates, because of the overwhelming information problems they would face — and that the theory's usefulness is for "general qualitative guidance." W. J. Baumol and J. G. Sidak, *Towards Competition in Local Telephony* (1994), at 37-41, especially 38-39.

This is, it must be stressed, a different issue from that raised by *required* departures from Ramsey prices.[41] If the calculation of valid Ramsey prices were possible, then at least the economic-efficiency comparison between them and the rates ultimately adopted would not be misleading. Where the conditions permitting Ramsey prices to be developed with reasonable confidence are absent, however, the comparison might as well be omitted as it will tell us nothing worth knowing.

What volume projection technique should be used? At the outset, we find Dr. Sherman explaining that he and Mr. Bernstein do not agree on the nature of the elasticity figures to be used. Mr. Bernstein uses a short-run elasticity figure to calculate future volumes[42]; Dr. Sherman advocates a long-run elasticity[43]. The difference in result is material. With the resulting uncertainty about how Ramsey prices would affect mail volumes, the impact of such prices on total future revenues cannot be projected confidently. If the revenues resulting from Ramsey prices are not known, then the breakeven postulate may not be satisfied — which would of course contradict the basic theory of such prices.[44]

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[41] For example, Dr. Sherman (OCA-T300 at 18, Tr. 26/13725) agrees with Mr. Bernstein that Ramsey prices would have to be modified for 11 of 21 subclasses, owing to the requirements of the Revenue Forgone Reform Act (Pub. L. 103-123, 103rd Cong., 1st Sess. (1993) at §§ 704 -708, 10 Stat. 1267 - 1273) and of § 3622(b)(3), forbidding cross subsidy (see particularly OCA-T300, Table 3, p. 21, Tr. 26/13728). This would be true even if perfectly reliable and complete cost and demand information were available.

[42] USPS-T31 at 43 ("using the long-run elasticity to forecast the Ramsey Test Year volumes would overstate the volume impact of the change from the before-rates price to the Ramsey prices.")

[43] OCA-T300 at 6-8, Tr. 26/13713-13715.

[44] I.e., that they optimally recover all the firm's costs where marginal-cost pricing would result in a deficit.

Cross-elasticity problems. If one recalls that Ramsey's original proposal was a theory of efficient universal taxation[45], it is easy to see the correctness of Dr. Sherman's testimony that the presence of large cross-elasticities will prevent the calculation of Ramsey prices.[46] Just as a taxing authority cannot levy a sales tax when shoppers can readily make purchases in a neighboring (non-tax) jurisdiction, so also Ramsey pricing can be applied only to captive trade — unless one makes the heroic assumption that cross-price elasticities between Postal Service offerings and all other services from the private sector are zero.[47] Elasticities change as price levels change, and if the change is both large and non-uniform across subclasses the possibility of accurately projecting cross-elasticities diminishes.[48]

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[45] F. P. Ramsey, "A Contribution to the Theory of Taxation," *Econ. J.*, vol. 37 (1927), 47.

[46] OCA-T300 at 41.

[47] Which is (to put it mildly) not the view the Postal Service has expressed elsewhere. See, e.g., the testimony of Postal Service witness McBride in Docket No. MC95-1, discussed at PRC Op. MC95-1, ¶¶ 2092 ff. Much theoretical work on second-best pricing does make this assumption, however. For discussion see R. Sherman and A. George, "Second-Best Pricing for the U.S. Postal Service," *Southern Economic Journal*, vol. 45, no. 3 (January 1979), at 685-695. Indeed, the assumption is not limited to services that compete directly with Postal Service subclasses. Intuitive cross-elasticities such as that between letter paper or greeting cards and postage are encompassed by it as well.

[48] That the change *due to adoption of Ramsey pricing* would be large and non-uniform is suggested by Mr. Bernstein's Table 11 (USPS-T31 at 56), which displays R94-1-based prices and Ramsey prices, and contains disparities such as:

	FWI Price (R94-1)	FWI Price (Ramsey)
Priority Mail	$4.4053	$2.4124
Periodical Non-Profit	0.1704	0.2409
Periodical Regular	0.2694	0.4724
Standard ECR	0.1630	0.0802
Standard Parcel Post	3.6199	4.1123

G. ACCURATE RAMSEY PRICING IS IMPOSSIBLE UNLESS THE DEMANDS OF THE PRODUCTS BEING TAXED ARE KNOWN

The effect of the letter monopoly. It is part of the theory of Ramsey pricing that the value assigned by consumers to different goods represents what they will purchase at various prices in an open market. If the markets in which some of these goods have to be purchased are not open, competitive markets, simply using the observed demands for the goods as inputs to the Ramsey procedure will not produce the results theoretically expected.

The market for postal services is not, of course, an open market. The observed demand for these services is conditioned by the governmental letter-mail monopoly. The Private Express Statutes[49] prohibit carriage of "letters"[50] by any carrier other than the Postal Service. Thus, no entrant may seek to supply any part of the aggregate demand for letter-mail service, even if its doing so would lower the average cost of such service for all consumers. Hence it is not clear that an own-price demand elasticity derived empirically from data reflecting the consequences of the letter monopoly would yield the results the Ramsey theory — which does not allow for the effects of an artificial monopoly — promises.

The Commission recognized this obstacle in Docket R84-1, without attempting to remove it.[51] In the next case, the problem was explained more fully but not resolved:

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[49] 18 U.S.C. §§ 1693-1695; 39 U.S.C. ch. 6.

[50] This term is defined by the Postal Service in regulations. 39 CFR § 310.1.

[51]

> There are other important, heretofore unaddressed analytic questions which must be dealt with before we would consider implementing a Ramsey pricing model. Several classes, notably First-Class letters, are subject to the postal monopoly, a factor which limits alternatives and has a major

> . . . The Act specifically states as postal policy that costs shall not be apportioned to impair the "overall value" of the service to the people. And the main goal of the Service is to provide service for the personal, educational, literary, and business correspondence of the people. 39 U.S.C. § 101(a). Such correspondence is reserved to the Postal Service by the private express statutes, which prohibit the private carriage of certain types of mail matter. Mail subject to the Postal Service's monopoly includes most of First-Class, and a substantial portion of third class.
>
> [4056] Since private enterprise cannot offer to compete for the business of delivering letters subject to the postal monopoly, mailers' alternatives are limited. Few satisfactory alternatives exist for a mailer seeking to obtain inexpensive, prompt, reliable delivery of hard copy. As prices increase for mail delivery, a customer without alternatives may choose to not send the message at all, but he can not switch to a competing carrier; as a result, the price elasticities for the letter subclasses are lower than they might be in an open market.

PRC Op. R87-1, ¶¶ 4055-4056.

In this case, there has been no attempt to reflect the effect of the monopoly in the Ramsey model. Postal Service witness O'Hara was asked, "If the elasticity of First Class Mail were due in part to the Private Express Statutes, what would be the significance of that fact?" He responded:

> The presumed effect of the Private Express Statutes in reducing the price elasticity of First-Class Mail provides a basis for mitigating, under criterion 5, the cost coverage that might otherwise be implied by this elasticity.

Response to NAA/USPS-T30-4, Tr. 2/182.

> impact on elasticity. How should that factor be accounted for? . . .

PRC Op. R84-1, ¶ 4132.

Hallmark of course does not disagree that the artificial scarcity produced by the Private Express Statutes should be factored into rates as a mitigation. But that is not the problem. Ramsey pricing has been presented as a canon for judging the "loss" from prices otherwise arrived at. But if the Ramsey formula itself produces cost coverages that must be corrected[52] on the basis of other knowledge, then those results cannot reasonably be thought of as canonical.

This is not the only way in which the Postal Service's attempt to establish Ramsey pricing as canonical ignores the real-world conditions facing First-Class letter mailers and recipients. For example, Mr. Bernstein offers several pages of testimony presenting Ramsey prices for single-piece and "workshared" letters.[53] The apparent basis of this exercise is that any letter whatever may convert from single piece to worksharing. His Ramsey prices for single-piece and workshared letters are 45 cents and 24 cents respectively, in contrast to before-rates prices of 39 cents and 27 cents.[54] He appears to give no recognition to the fact that mailers of single-piece letters are generally not free to perform discount-generating worksharing activities.[55] Of course, when he applies his favored pricing scheme to single-piece and workshared letters separately, he is implicitly choosing to ignore the Commission's decision in Docket No. MC95-1 that single-piece and automated First-Class letters should not be made separate subclasses for pricing purposes[56].

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[52] Judgmentally, it would appear.

[53] USPS-T31 at 82-93. He assumes that only one worksharing category, with a discounted price, needs to be established.

[54] USPS-T31 at 87, Table 17. These are all fixed-weight index prices.

[55] See *Domestic Mail Classification Schedule,* §§ 221.22 (presorted First-Class letters), 221.31 (Automation letters); *Domestic Mail Manual* §§ E 130, 3.0 (presort), E 140 (automation).

[56] PRC Op. MC95-1, ¶¶ 5030-5034.

H. POTENTIALLY UNDESIRABLE RESULTS OF APPLYING RAMSEY PRICING TO THE POSTAL SERVICE

Heretofore in this brief, we have concentrated on the fallacies in the Postal Service's assertion that a Ramsey price schedule can or should serve as a canon by which to evaluate other sets of prices.[57] There remain some significant disparities between the results theoretically expected from Ramsey pricing and the results that should be expected to follow if (setting aside statutory requirements and evidentiary shortcomings) it were actually used to set postal rates. We therefore add a few words about these disparities — whose effects would not necessarily be remediable by Commission action, but would nonetheless be traceable to a Commission decision on pricing principles.

Ramsey pricing fully accepts and treats as unproblematic the costs used as a basis for pricing. Specifically, it assumes that whenever and wherever a causal relationship exists between the provision of a unit of service and the incurrence of a quantum of cost, that relationship will be disclosed in the relevant accounting system, will be recognized by the price-setter, and will result in the allocation of the cost to the service before the remaining, non-traceable costs — which are assumed to be incurred efficiently[58] — are assigned on the basis of relative demand. These heroic

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[57] We have done this while recognizing that the Postal Service is not actually proposing Ramsey rates — in this case — but rather is attempting to lay the groundwork for their institution in the future. For if it were accepted that Ramsey prices are the benchmark for prices in general, and the special circumstances pointed to by Dr. O'Hara (USPS-T30 at 21) were (allegedly) absent in future cases, there would arguably be no reason not to move to Ramsey prices.

[58] See Tr. 10/5114-5116. Unless the non-traceable costs are incurred in an efficient manner, their allocation for pass-through cannot be viewed as a step taken for purposes of efficiency. The meaning of "efficiency" is not exhausted by the notion of "allocatively efficient" relative prices as among mail services. If *all* mail services cost more than they should, society necessarily — and inefficiently — spends on them resources it could put to better use elsewhere.

assumptions are necessary to the Ramsey theory, which postulates accurate marginal cost figures as a basis for pricing. Unfortunately, these same assumptions neglect the numerous practical constraints and sources of error[59] afflicting postal cost ascertainment and accounting, and presume that the real-world system of Postal Service accounts can accurately disclose marginal costs.

Such causal cost relationships may however be ambiguous — as, for instance, when administrative personnel costs are not attributed but treated as institutional even though a theoretically complete system of cost ascertainment would link at least part of *their work hours with particular subclasses. In this case, not only would marginal costs* be misrepresented; also the costs that — in a cost accounting system sufficient for Ramsey pricing — should be attributed on the basis of causation would, absent such a system, become available for differential pricing. Where the Postal Service found or assumed a competitive basis for the perceived high price elasticity of certain subclasses, it would have additional leeway to cut those subclasses' rates. Under a Ramsey-pricing regime, all of this leeway would be available to the Postal Service as raw material for competitive pricing proposals: it would not be "diverted" into promotion of ECSI value, preservation of fairness, or mitigation of rate shock.

The situation thus presents postal management with at least two sorts of perverse incentives: (i) the temptation to keep (or render) cost-causation relationships

[59] For example, the controversy over the treatment of "not handling mail" tallies has generated formidable testimony and argument on both sides. See, e.g., the testimony of Time-Warner witness Stralberg (Tr. 26/13840-13852), and USPS-RT6 (Degen) and USPS-RT8 (Steele), disputing it. The Commission presumably will have to arrive at a record-based resolution of the problem — but may, equally, find that no resolution inspires unqualified confidence. Cf. PRC Op. R90-1, ¶¶ 5245-5246.

obscure or ambiguous[60], and (ii) the temptation to plan or invest preferentially in unattributable resources.[61]

Ramsey pricing is put forward as an efficient way to allocate non-attributed "institutional" postal system costs. The theory behind Ramsey prices accepts these costs as a given and focuses on their allocation to the most captive customers. In doing so it neglects potentially greater questions about inefficiently passing through costs that should be avoided.[62] A second great concern should be the discovery of what are truly non-attributable costs. Passing those costs through to the small mailer who is for now captive[63] will inherently (if tacitly) reflect accounting judgment, not the precise economic science claimed to support the underlying Ramsey pricing theory; and it could readily become a matter of passing through institutional inefficiencies — such as costs actually due to redundant managerial and labor resources — to the least favored groups of mailers. This hardly smacks of economic efficiency in any guise.

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[60] See, e.g., Tr. 26/13840-13841 (Time-Warner witness Stralberg). Periodicals are said to be a notably inelastic category.

[61] This effect is akin to the Averch-Johnson effect perceived in regulated gas and electric utilities. Traditional ratemaking, with its procedure of allowing a percentage return, greater than the marginal cost of capital, on investment dedicated to utility service (rate base) gives the utility the incentive to overinvest in plant in order to inflate the base on which return is computed. H. Averch and L. L. Johnson, "Behavior of the Firm Under Regulatory Constraint," *American Economic Review*, vol. 52 (1962), 1052-1069; and see discussion in A. Kahn, *The Economics of Regulation* (1971), II, 49 ff.

[62] The Commission noted the existence of this problem at PRC Op. R84-1, ¶ 4139.

[63] Pending diffusion of technology which might allow small mailers to bypass the postal system entirely, without sacrificing the unique non-economic values inherent in personal correspondence. One might speculate, of course, that excessive loading of costs on such mailers will only hasten the diffusion of such technology, by creating a more intense demand for easy-to-use, low-priced means of exploiting it.

Unless one can confidently say (which one cannot) that the non-attributed costs to be recovered through Ramsey price mark-ups are only costs that would be incurred in an efficient enterprise, one cannot claim that soaking the most captive customers for the largest share of such costs is "efficient."

I. OTHER SECTIONS OF THE ACT REQUIRE THE COMMISSION TO GIVE WEIGHT TO USER CONSIDERATIONS NOT REFLECTED IN RAMSEY PRICING, AND TO NON-MONETARY AS WELL AS MONETARY VALUES

In order for a pricing scheme to be adopted for postal ratemaking, the effects of the rates the scheme generates must be first estimated and then tested from the standpoint of the objectives of the Act. Under § 3622(b)(4) of the Act, a pricing regime may not be adopted unless and until consideration has been given to the impact of the resulting rates on users of the mail. As explained in the testimony of GCA witness Erickson, both senders and recipients of the mail are users of mail.[64] This view of usership comports fully with the Act's purposes, 39 U.S.C. 403(b)(1), and its concern with mail recipients as well as mailers.

Ramsey pricing cannot capture the non-quantifiable effects of a transaction and may also miss some quantifiable external costs. Therefore its exclusive focus on mailers' demand will fail to consider how the resulting rates will affect mail recipients, and indeed even mail senders. Ramsey pricing concerns itself only with mail senders, and the effect of Ramsey prices on mail recipients is outside the scope both of Ramsey analysis itself and of the cases put forward by the Postal Service and others to justify

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[64] Tr. 25/13174-13181, 13185-13186, 13196-13200. Indeed, the same proposition is probably inherent in Mr. Bernstein's attempt (analyzed at pp. 9-11 above) to distinguish between value of mail service and value to the recipient of the content of the mail. It is difficult to see how one could acknowledge that a recipient may value what comes in the mail without also treating that recipient as a "user" of the mails.

Ramsey pricing in this proceeding. Moreover, Ramsey pricing's demand analysis could not address the question of whether the resulting rates would be consistent with Congress's *mandate "to provide types of mail service to meet the needs of different categories of mail and mail users,"*[65] — *unless the Commission were to adopt the* position, which it has already rejected[66], that the needs of mail users should be distilled into a mailers' demand analysis with all other monetary and non-monetary impacts disregarded.

Similarly, unless one adopts the position that it is fair and equitable for the Postal Service to use its statutory monopoly to impose the highest institutional-cost assignments on mail senders who, because of that legislative, have no communication alternatives, one can not claim that Ramsey pricing can comport with the Act's requirement of rates that are fair and equitable, § 3622(b)(1).

Basically, to adopt Ramsey pricing the Commission would have to elevate its economic theory — together with that theory's disregard for externalities[67] — over the mandates of the Act regarding non-monetary values and recipients' interests. It would also have to disregard the want of evidence by proponents of Ramsey pricing in this proceeding regarding the effects of Ramsey prices on most mail groupings and users of the mail.

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[65] 39 U.S.C. § 403(b)(2).

[66] See p. 19, fn. 31, above.

[67] Such as the positive externalities associated with the cultural value greeting cards provide to recipients, as described in Dr. Erickson's testimony. See Tr. 25/13167-13170, 13173-13181, 13187-13195.

J. THIS CASE PRESENTS AN OPPORTUNITY TO GIVE THE PROPER RATEMAKING WEIGHT TO THE ACT'S IMPORTANT PUBLIC SERVICE CRITERIA

The Act established the Postal Service to serve rather than to tax the American people. The Act states that the purpose of the Postal Service is to "bind the Nation together through the personal, educational, literary, and business correspondence of the people." 39 U.S.C. § 101(a). In setting forth the specific criteria that the Commission is to apply in setting postal rates, the Act goes beyond the criteria for economic efficiency (i.e., rationing), incorporates that purpose-and-policy section and requires that the Commission should in setting rates seek to foster culture and should be mindful of the interests of mail recipients. While the Postal Service would direct attention away from operating efficiency and its mandate to foster and not ration mail usage and toward battles among classes of mail regarding which groups are most heavily taxed to support Postal Service institutional costs, the Act instructs the Commission to respect and promote non-economic values in ratemaking.

In this proceeding, the Greeting Card Association, of which Hallmark is a member, has presented as a witness Dr. Ken Erickson, an anthropologist, to testify to the cultural value of sending and receiving greeting cards through the mails (GCA-T1, Tr. 25/13151-13215). Dr. Erickson's testimony, after introducing what is meant by the term "culture" (Tr. 25/13162-13171), discusses the cultural value and role of greeting cards, and sets forth the results of his survey research regarding the significance of greeting cards in our national culture. Tr. 25/13173-13215. He explains how sending and receiving greeting cards helps bind the nation together by linking families and friends through shared cultural meanings, and how greeting cards are important in the way we express our personal relationships, and thus our culture. Tr. 25/13185-13200, 13250-13253, 13256.

Dr. Erickson provides expert testimony explaining the importance of not impairing the mailing and receipt of greeting cards in times of joy and in times of stress and bereavement. The cultural value of sending and receiving greeting cards is more than a mere matter of dollars and cents. This fact is important methodologically as well as for the specific outcome of this rate case. Dollars-and-cents measures of significance work when applied to the behavior of *purchasers* — but both in Dr. Erickson's research and in the Act stress is laid on the value of mail to *recipients*. Thus the Commission cannot — whether or not it has the benefit of testimony like Dr. Erickson's — treat cultural value merely as a numerical tradeoff against relative demand or economic "value of service" in the § 3622(b)(2) sense. The two sets of values (as Dr. Erickson also testified, Tr. 25/13167-13169) are simply incommensurable, but the Commission must give effect to both. Correspondingly, the *economic analysis represented by Ramsey pricing cannot be used* (as Mr. Bernstein and others use it) as a standard to judge application of the non-economic values to ratemaking. That is why the Commission's historic approach of *judgmentally* balancing the pricing factors of § 3622(b) is the right one:

> For a well-schooled man is one who searches for that degree of precision in each kind of study which the nature of the subject at hand admits. . . .

Aristotle, *Nicomachean Ethics*, I.3, 1094b. Dr. Erickson's testimony has increased the degree of precision possible in postal ratemaking[68], by making the interpretation of §§ 3622(b)(8) and 101(a) more concrete and specific, but has not turned it into a mechanistic computing process.

Under Sections 101(a) and 3622(b)(8) of the Act, the cultural and other non-economic value of mail is to be fostered and not rationed. The Commission, with Dr. Erickson's testimony, has the tools to give ECSI values the weight the statute requires

[68] Tr. 25/13238.

— that is, a weight co-equal with that given economic subjects. In using these tools, the Commission should remind the Postal Service of its responsibilities as a public service to senders and recipients of all kinds of mail, and not merely a commercial enterprise seeking to serve the most profitable types of mail and to charge what the traffic will bear.

It is also important that, through Dr. Erickson's testimony, the Commission has concrete and compelling reasons to accord more recognition to the ECSI value of First-Class letter mail. The Commission has already recognized, in a general way, that First-Class letters have ECSI value; now it can, and should, accord more weight to the cultural values served by such mail.[69]

III. SUMMARY AND CONCLUSION

The conclusion Hallmark draws, and urges the Commission to draw, from the record on pricing theory in this case is relatively simple: nothing justifies either (i) promotion of demand pricing to a preeminent position in ratemaking, or (ii) departure from previous Commission pricing practice. Briefly:

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[69] See PRC Op. R87-1, ¶¶ 4101 ff. Postal Service witness O'Hara stated that his proposed rates were meant to adhere to the Commission's view of First-Class Mail's ECSI significance as set out in the R87-1 opinion. Response to OCA/USPS-T-30-7(d), Tr. 2/214; Tr. 2/219.

We do not suggest that in giving First-Class letters more ECSI recognition the Commission would have to accord less to other relevant classes, such as Periodicals or book rate. Applying § 3622(b)(8) is not a zero-sum game. If the record shows that ECSI considerations should direct the distribution of more institutional-cost dollars than previously, the role of these considerations can and should increase. Thus the Commission is free to increase the overall influence of § 3622(b)(8) on its recommended rate schedule if the evidentiary record so requires — as we strongly believe it does in this case.

The Act's pricing factors are co-equal in status. Relative demand is only one of them; it cannot be singled out and made the principal standard or canon by which applications of the pricing provisions as a whole are to be judged. But Ramsey pricing, as presented by its advocates in this case, would do precisely that.

A theoretical decline in allocative efficiency cannot be put forward as the only type of "loss" in which the Commission should take an interest when rates must be increased. The Act requires the Commission to consider — and recommend rates that will minimize — losses in value to recipients as well as senders, and losses in unquantifiable values as well as in dollars and cents. The statute forbids these values to be summarily labeled "externalities" and left out of, or effectively disregarded by, Ramsey equation-driven ratemaking. But the Ramsey theory's basis — demand pricing — focuses only on purchasers (senders), to the total disregard of recipients; and it ignores all factors except how much postage senders will be made to pay (neglecting the *non-economic* value they, as well as recipients, lose if they do not purchase postage).

The Postal Reorganization Act, as its first section declares and later sections require in detail, is designed to *promote* the unifying and enriching effect of postal communication. Ramsey pricing, however, is a rationing mechanism which selectively restrains demand for postal services without regard to this overriding policy.

Ramsey pricing aims only at maximization of allocative efficiency under a breakeven constraint. Hence it not only requires numerical expression of all factors it considers; it must also rest on *accurate* demand and marginal cost information if it is to be more than an arbitrary charade. When presented on a theoretical level, it simply assumes the correctness of the available numbers. But the record in this case, which features among other things a new and controversial system of attributable-cost estimation, and novel attempts — which many find deficient — to distribute significant cost elements to classes, gives little reason to hope that the needed accuracy is attainable. Values of "externalities" remain unquantified. Comparing a rate schedule arrived at through sound, balanced judgment with a Ramsey exercise performed on dubious numbers would tell the Commission nothing worth knowing about any supposed "loss" in efficiency from obeying the statute.

Among the difficulties of balancing the ratemaking criteria of the Act is that some of them reflect inherently quantifiable values and others do not. But the latter — including especially the educational, cultural, scientific, and informational value to recipients of mail matter [§ 3622(b)(8)] — are just as important as the former. In this case, the difficulty of assessing cultural value has been lessened by the testimony of GCA witness Erickson on the meaning for American culture of greeting cards, a major component of single-piece First-Class letter mail. This testimony shows that the overall significance of the ECSI criterion is even greater than has been recognized in the past, and that it pertains to First-Class single-piece letters even more substantially than previously supposed. It supplies yet one more reason for the Commission — as we have urged in section II.C. of this brief — to reject the "Ramsey agenda" and to reaffirm and again employ its historic, and legally correct, balancing process for the setting of postal rates.

The Act is very clear in its requirements that the interests of recipients as as well as of senders must be considered in determining how Postal institutional costs are taxed through postal rates. It is also very clear in its requirement that in determining how these costs are to be taxed the Commission is to balance non-quantifiable considerations of fairness and equity and of the fostering of ECSI values together with those economic considerations which have been reduced to numbers. This process mandated by the Act can be done by continuing the Commission's traditional balancing approach - using the new information provided by Dr. Erickson, the GCA witness. This process can not be done by using a ratemaking scheme driven by the canon of

Ramsey pricing. The Postal Service's proposal to elevate Ramsey pricing into the canon for Postal ratemaking should be emphatically rejected and the balanced consideration of all statutory factors should continue to be the Commission's course.

Respectfully submitted,

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April 1, 1998

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding, in accordance with § 12 of the Rules of Practice.

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